

California Tax Policy Conference  
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"Tangible Personal Property for Apportionment Purposes"

## **I. Relevance of Tangible Personal Property for Apportionment Purposes**

According to California Revenue & Taxation Code section 25101<sup>1</sup> a corporate taxpayer that does business within and without California will have its California-sourced income determined by California's version of the Uniform Division of Income for Tax Purposes Act (i.e. UDITPA), which is contained at sections 25120 – 25137.

### **A. Factors**

Section 25128 provides that apportionable business income shall be assigned to this state by means of multiplying it by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four.

#### **1. Property Factor**

Generally, according to section 25129, rented or used "tangible personal property" is included in the property factor.

##### **a. Banks and Financial Corporations – Allocation and Apportionment of Income**

Title 18, California Code of Regulations section 25137-4.1<sup>2</sup> – For Income Years Beginning Before January 1, 1996: Section 25137-4.1(c)(1)(A)(i) – Banks and financials could include in the property factor "owned intangible personal property ... as its tax basis for federal income tax purposes."

CCR section 25137-4.2 (Effective April 20, 1996): Section 25137-4.2(d)(1) – Banks and financials can only include in the property factor "the average value of the taxpayer's loan and credit card receivables located or used within and without this state during the income year."

#### **2. Sales Factor**

Section 25134 provides the rules for determining how various sales are reflected in the sales factor.

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<sup>1</sup> Hereinafter all statutory references are to the California Revenue & Taxation Code, unless otherwise noted.

<sup>2</sup> Hereinafter all regulatory references are to Title 18, California Code of Regulations.

## **a. Tangible**

Section 25135 assigns sales of "tangible personal property" to this state if they're "shipped or delivered" to a purchaser in this state.

### **(i). "Destination Rule"**

California Court of Appeal held in *McDonnell Douglas v. FTB*, (1994) 26Cal. App. 4<sup>th</sup>, 1789, 1796, that sales of "tangible personal property" are assigned to the ultimate destination jurisdiction.

## **b. Other than Tangible**

Section 25136 provides the general rule for assigning sales of "other than tangible personal property" to this state, while CCR section 25136 provides the specific rule for assigning these sales under a "greater costs of performance" criterion.

## **B. Need for Definition**

Because of the use of the term for sales factor and property factor purposes there is a need for a controlling definition of the term.

### **1. Statutory**

Section 25120, which provides the applicable definitions for UDITPA purposes, does not include a definition of the term.

#### **a. Part 11 of Division 2 of the California Revenue & Taxation Code**

This Part encompasses the California Corporation Tax law. It also does not contain a definition of the term.

#### **b. Part 1 of Division 2 of the California Revenue & Taxation Code**

This Part encompasses the Sales and Use Tax Law and does contain a definition of the term. Section 6016: "'Tangible personal property' means personal property which may be seen, weighed, measured, felt or touched, or which is in any other manner perceptible to the senses.'" However, this definition is only applicable for sales and use tax purposes. It must be noted that definitions, concepts, and distinctions from one set of tax laws cannot be carried over to others because each area of tax law is shaped by its own provisions and definitions in accordance with its own perceived policies and concepts. (See *United State Lines, Inc. v. State Board of Equalization* (1986) 182 Cal.App.3d 529; see also *Standard Oil Co. v. State Board of Equalization* (1965) 232 Cal.App.2d 91, wherein the court held that definitions within the Revenue and Taxation Code relating to property tax were not controlling for sales tax purposes.)

## **2. Regulatory**

### **a. Title 18, California Code of Regulations**

No definition provided.

### **b. Treasury Regulations**

Section 1.48-1(c) – "[T]he term 'tangible personal property' means any tangible property except land and improvements thereto..."

This is a circular definition. It uses to the undefined term "tangible property" to define "tangible personal property". Definition is only applicable for general business credit purposes.

## **II. Definition of Component Parts of Term "Tangible Personal Property"**

### **A. "Tangible"**

#### **1. SBE Cases**

*Appeal of Retail Marketing Services, Inc.*, Cal. St. Bd. of Equal., Aug. 1, 1991, 91-SBE-003, the taxpayer purchased coupons from various merchants and resold them to the manufacturers that issued them. The taxpayer included in its property factor the cost paid for the coupons held at the end of the year. The taxpayer relied on the Funk and Wagnall's Standard College Dictionary (1963 edition) definition of "tangible," that is, something that is perceptible by touch and the senses. Using this definition, the taxpayer argued that the coupons qualified as tangible personal property, and should be reflected in its property factor, because they were perceptible to touch and the senses. The SBE acknowledged "the ordinary and customary meaning of 'tangible' is that which can be felt by touch, having actual form and substance. Basically the definition of 'tangible' set forth in this case is the standard dictionary definition.

#### **2. Restatement of the Law of Conflict of Laws**

Section 46, comment C: "Things are either tangible or intangible. A tangible thing is one which has physical substance. All other things are intangible."

#### **3. Legal Dictionaries**

Black's Law Dictionary (6<sup>th</sup> Ed.) 1990, page 1456 – "Tangible property: Property that has physical form and substance and is not intangible. That which may be felt or touched..."

## **4. Legal Commentaries**

"[M]any rights do not ... concern specific tangible things but consist of claims ... [that] are of value and thus entitled to be termed property in the broader sense.... To distinguish between [the] two classes, lawyers have from early times used the terms choses (i.e. things) in possession, and choses in action. Thus choses in possession refer to rights in definite tangible things over which possession may be taken, and choses in action to rights of property which can only be claimed or enforced by action, and not by taking physical possession". (Brown, *The Law of Personal Property* (2d ed., 1955), section 7, p.13.)

### **B. "Personal"**

#### **1. California Civil Code**

Section 657, a statute of general application, classifies "property" as either "real" or "personal". Civil Code section 658, also a statute of general application, defines "real" property as land, or that which is affixed, incidental, or appurtenant to it. Therefore, by exception, "personal" property is property that does not relate to land.

### **C. "Property"**

With respect to the term "property," in a legal context, it refers to a collection of rights. As stated in *Hoyd v. Citizens Bank of Albany Co.* (6th Cir. 1937) 89 F.2d 105, 107, "[p]roperty is a nomen generalissimum [i.e., general term] and extends to every species of valuable rights and interest...." As one scholarly commentator has noted, "[i]n its widest sense, property includes all a person's legal rights, of whatever description." (Fitzgerald, *Salmond on Jurisprudence* (12th ed. 1966), section 108, p. 411.)

## **III. Definition of Components of "Other than Tangible"**

### **A. "Intangible Property"**

#### **1. SBE Cases**

*Appeal of The Babcock and Wilcox Company*, 78-SBE-001, January 11, 1978 – "Personal property may be either tangible or intangible." *Appeal of Retail Marketing Supra* - "[P]roperty that is a right rather than a physical object is intangible."

#### **2. Case Law**

"[R]ights which are not related to physical things." *Curry v. McCanless* (1938) 83 L.Ed. 1339, 1347. "[P]roperty is intangible if its intrinsic value is attributable to its intangible elements rather to any of its specific tangible embodiments." *Texas Instruments v. U.S.* (1977) 551 F.2d 599, 609.

### 3. Legal Commentaries

"It is necessary ... to note that certain written and printed instruments [are] in their primary essence ... mere evidences of the obligation of the parties...." (Brown, *The Law of Personal Property* (2d ed., 1955), section 7, p.13.) Therefore, although intangible property can be represented in some physical medium, such as stock certificates and bonds, such things are only the manifestation of the underlying rights that they represent and are not the property right itself.

#### D. "Service(s)"

##### 1. Regulatory

a. **CCR section 25136(d)(2)(C).** Assigns gross receipts for the performance of *personal services*. If done within and without the state, the gross receipts are assigned on a ratio of time spent performing the services in this state compared to the total time spent in performing such services everywhere. No definition of the term "personal services" provided. However, two specific examples provided. First example involves the performance of a theatrical road show, the other relates to a company's employees conducting an opinion poll.

##### 2. Legal Dictionaries

Black's Law Dictionary (6<sup>th</sup> Ed.) 1990, p. 1368-9 - "[S]ervice relates to duty or labor that is performed by one person to another". "[S]ervices are [t]hings purchased by consumers that do not have physical characteristics (e.g. services of doctors, lawyers, dentists, repair personnel)."

### IV - Apportionment Issues

#### A. Sales Factor

##### 1. Electricity - Appeal of PacifiCorp

###### a. Fact Pattern

Oregon-based power company sold over \$470 million of electricity to California-based power companies, municipalities and California government agencies. All of the electricity had been generated outside of California. According to the terms of the various contracts, title to the electricity transferred at a location outside of California. For sales factor purposes, taxpayer treated the sales of electricity as sales of "other than tangible personal property". Accordingly, the \$470 million wasn't reflected in the taxpayer's California sales factor numerator. On audit, FTB included the \$470 million in the taxpayer's California sales factor numerator.

## **b. Taxpayer's Position**

Taxpayer's argued that since the Franchise Tax Board did not necessarily have an affirmative position that held that electricity qualified as tangible personal property, that it was improper for the FTB auditor to make the adjustment in the first place. Taxpayer also argued that the proper test for determining whether something qualifies as "tangible personal property" is the "standard" that is set forth in *Appeal of Retail Marketing Services, Inc.* which provides: "[T]he ordinary and customary meaning of 'tangible' is that which can be felt by touch, having actual form and substance". Furthermore, taxpayer also relied heavily on a comment included in a footnote of a 1921 California Supreme Court case, *Abner Miller v. City of Los Angeles*, (1921) 185 Cal. 440, which provides, "Electricity is rather an intangible asset ...". According to the taxpayer, the *Miller* case controls the question of whether electricity is tangible.

## **c. FTB's position**

A variety of legal authorities stand for the proposition that "tangible" things exhibit physical characteristics. These authorities include *Appeal of Retail Marketing Services, Inc.* supra. The FTB's expert witness, Joel Fajans, who is a physics professor at U.C. Berkeley, produced a report detailing the physical characteristics of electricity. Since electricity exhibits physical characteristics, legally it qualifies as something that is "tangible". Accordingly, the sales of electricity that appellant made to the California-based customers should be included in its California sales factor numerator.

## **d. SBE's Decision – September 12, 2002**

"[S]ales of ... electricity here were sales of services performed for the most part outside of California.... Therefore, based on the foregoing discussion, we conclude that, for purposes of California tax law, electricity is intangible."

## **e. FTB's Petition for Rehearing**

Board's decision is in direct contradiction with controlling California Supreme Court authority that holds that the essential commercial nature of electricity is that it is property and not a service. "In a broad analysis of the term it can hardly be disputed that electrical energy as manufactured and supplied for public and private use is property." (*Abner Miller v. City of Los Angeles*, (1921) 185 Cal. 440, 443.)

Furthermore, the use of the term "intangible" in defining the treatment of sales of electricity for California tax law is inconsistent with the rationale in the decision. "Intangible" is a term that is used to qualify "property." (See *Appeal of The Babcock and Wilcox Company*, 78-SBE-001, January 11, 1978.) There is no such thing as an intangible service. If the Board meant to imply that electricity is intangible property, then the decision needs to be revised to explicitly state that. Accordingly, if the Board finds the sale of electricity to be the sale of an intangible, the Board must reconcile that decision with *Appeal of Retail Marketing Service, Inc.*, 91-SBE-003, August 1, 1991,

which states: "[P]roperty that is a right rather than a physical object is intangible". As such, if the Board believes that electricity is intangible property, then the Board's decision also needs to explain how electricity qualifies as a right.

Alternatively, if the Board did not intend to imply that sales of electricity are sales of intangible property, then the Board should replace the term "intangible" in the last paragraph of the decision with the term "other than tangible property."

## **2. Billing Services - Appeal of U.S. Computer Services**

### **a. Fact Pattern**

U.S. Computer Services was a leading provider of customer management software and services to the communications industry. The company's clients include providers of cable television, wireless and land line telephony, direct broadcast satellite and multiple communications services in the U.S. and 13 other countries. It provides bill presentment services, which include the generation of high quality, customized billing statements. The bill presentment services were the subject of this appeal. The Company provided bill presentment services in a fully integrated and automated production environment that rapidly and cost-effectively transformed electronic data received from the client into informative, accurate and customized billing statements. The taxpayer was apportioning its income from billing services operations as sales of tangible personal property. The FTB made an adjustment to the sales factor to allocate sales of billing services under section 25136 (which governs sales of other than tangible personal property), rather than section 25135 (which governs sales of tangible personal property).

### **b. Taxpayer's Position**

Its customers were paying it to produce a finished invoice, which qualified as tangible personal property. That invoice created by taking billing information from the customer, making an envelope, printing the statement, and mailing the bill to the "ultimate" customer. According to the "intrinsic value" test in Appeal of Retail Marketing, the intrinsic value of the billing statement is the statement itself.

### **c. FTB's position**

In the Appeal of Mark IV Metal Products, Inc., 82-SBE-181., August 17, 1982, the SBE held that the utilization of material provided by a customer, in the fabrication of an item for that customer, indicates that what is being provided is a service. With respect to U.S. Computer Services, it is fabricating bills using its own labor and equipment and utilizes the customer's accounts receivable as the raw material. Although the raw material is different from the Mark IV case, it is similar in that in both cases the primary item essential to the taxpayer's business is an item not owned by the taxpayer. In both cases the taxpayers are paid to manipulate the customer's property. In Mark IV it is

steel; in this appeal, it is accounts receivable. Section 25136 should apply in both cases.

#### **d. SBE's Unpublished Decision**

"[T]he Board of Equalization ... concluded that [U.S. Computer Services] bill presentment activities constitute the sale of tangible personal property for purposes of the sales factor of the apportionment formula."

### **3. Computer Software**

#### **a. "Canned"**

Software produced for use by the general public, is treated as a sale of tangible personal property, similar to the sale of a book, compact disc, DVD, etc.

#### **b. "Custom"**

Software produced for a specific customer's need. It has been treated as a sale of other than tangible personal property and is assigned based on "greater costs of performance". The underlying theory is that the tangible manifestation of the software, i.e. cd-roms, is "incidental" to the programming services. However, there is a theoretical basis for treating sales of custom software as sales of tangible personal property. The purchaser of the custom software wants a program that will serve a specific function. The purchaser doesn't care whether the programmer meets their need with "canned" software, by modifying "canned" software, or by custom designing software. The key issue is what is the purchaser buying, the seller's services or tangible goods?

### **4. E-Commerce**

#### **a. American Business Information v. Nebraska (2002) 264 Neb. 574**

American Business Information ("ABI") compiled a database of 10 million businesses in the U.S. and Canada. This database could be accessed over telephone lines by using computer equipment capable of receiving, interpreting and storing an electronic signal transmitted by ABI. Customers could then conduct their own search query and download data directly from ABI's database. For apportionment purposes, ABI treated the revenue generated from the online access of its database as sales of tangible personal property. The Nebraska Department of Revenue reclassified the revenue as "other than sales of tangible personal property." The Nebraska Supreme Court ruled "ABI's delivery of online data electronically over telephone lines 'is the transmission of a tangible thing.' We therefore conclude that the[ir] sale ... is a sale of 'tangible personal property.'"



## **B. Property Factor Issues**

### **1. Appeal of Retail Marketing Services, Inc. Supra.**

#### **a. Fact Pattern**

The taxpayer purchased coupons from various merchants and resold them to the manufacturers that issued them. The taxpayer included in its property factor the cost paid for the coupons held at the end of the year.

#### **b. Taxpayer's Position**

The taxpayer relied on the Funk and Wagnall's Standard College Dictionary (1963 edition) definition of "tangible," that is, something that is perceptible by touch and the senses. Using this definition, the taxpayer argued that the coupons qualified as tangible personal property, and should be reflected in its property factor, because they were perceptible to touch and the senses.

#### **c. FTB's Position**

The coupons in question had no inherent value in and of themselves, but only represented a value to a consumer in the amount of the discount which would be eventually exchanged for cash, and as such constituted intangible property.

#### **d. SBE's Decision**

Citing *Texas Instruments v. U.S.*, the SBE held that property is intangible if its intrinsic value is attributable to its intangible elements rather than to its specific tangible embodiments. Therefore, by applying this "intrinsic value" test, the SBE concluded that the intrinsic value of the coupons was attributable to their intangible elements rather than to their tangible embodiments and should not be reflected in the property factor.

### **2. Computer Software**

#### **a. FTB's Multistate Audit Technique Manual Section 7152**

"In the past, the department had taken the position that canned or prewritten software should be treated as tangible property, and custom software should be treated as intangible property. This characterization was consistent with the treatment for California sales tax purposes. Based on the California Supreme Court's decision in *Navistar International Transportation Corporation v. State Bd. of Equalization*, (1994) 8 Cal.4<sup>th</sup> 868, however, the position may be taken that both canned and custom software are tangible property and therefore includable in the property factor.... Although *Navistar* was a sales tax case, the Court's express statement that computer programs are tangible personal assets is not based upon a sales tax statute, and should not be limited to that context. When applied in a property factor context, *Navistar* supports the

position that as soon as custom software has been developed and is placed in service in the unitary business, it is tangible personal property includable in the property factor."

In December 1994 the FTB issued Legal Notice 94-8, which states: "The Franchise Tax Board staff issues manuals to its audit personnel to provide guidance on department practices, summaries of pertinent law, and auditing techniques. While the manuals are available to the public on request, they are intended for Franchise Tax Board staff use only.... Questions have arisen as to the legal effect of these manuals. These manuals are merely audit guidance at the time written, and are not authoritative interpretations of law. Thus, statements in these manuals are not legally binding upon either taxpayers or the Franchise Tax Board." Nonetheless, The MATM can be accessed via the internet at [www.ftb.ca.gov/manuals/audit/matm](http://www.ftb.ca.gov/manuals/audit/matm).)